OAH 4-3600-20809-5

STATE OF MINNESOTA
OFFICE OF ADMINISTRATIVE HEARINGS

FOR THE BOARD OF TRUSTEES
OF THE PUBLIC EMPLOYEES RETIREMENT ASSOCIATION

In the Matter of the PERA Salary Determinations Affecting Retired and Active Employees of the City of Duluth

ORDER

Allen Johnson, et al., Petitioners

On April 13, 2010, Administrative Law Judge Bruce H. Johnson (the ALJ) conducted a hearing on the parties' cross-motions for summary disposition at 9:30 a.m. at the Duluth City Council Chamber, Third Floor, Duluth City Hall, 411 West First Street, Duluth, MN 55802. The record closed on April 20, 2010, when the parties filed additional post-hearing submission that the ALJ requested.

Jon K. Murphy, Assistant Attorney General, appeared on behalf of the staff of the Public Employees Retirement Association (PERA). Elizabeth Storaasli, Attorney at Law, Dryer, Storaasli, Knutson & Pommerville, Ltd., appeared on behalf of a group of Petitioners, all retired Duluth firefighters (Represented Petitioners),[1] and Petitioners Bryan F. Brown, Attorney at Law, John Hall, Mark Wick, Pamela Woods, John Keenan and Claudia Johnson each appeared *pro se* and spoke at the hearing. Petitioners Helen Abbott, James Charbonneau, Thomas Ehle, James Irving, Jeffrey Johnson, Richard Kienzie, Carolyn Luxon, Robert Mills, and Arthur Zylka also appeared *pro se* at the hearing but did not speak. Several other active or retired employees of the City of Duluth, who have not been made parties to this proceeding, were also present.

Based upon all of the files, records, and proceedings herein, and for the reasons set forth in the accompanying Memorandum, the Administrative Law Judge makes the following:

[1] Specifically, Petitioners Paul Ostman, Doug Michog, John Edwards, Mark Behning, Terry Purcell, Doug Belanger, Dave Salveson, Anne Peterson, L. J. Harvey, William L. Johnson, and Dave Wedin.

ORDER

IT IS HEREBY ORDERED that:

(1) Discovery in this proceeding is hereby re-opened until June 30, 2010, for the sole purpose of further developing the record regarding the income tax treatment of amounts paid by the City of Duluth to the Petitioners' deferred compensation plans or family health insurance plans during the period 1995 through September 2008, as discussed more particularly in the Memorandum that follows;

(2) The parties shall have until the close of business on July 16, 2010, to submit for inclusion in the record of this proceeding any further evidence regarding the unresolved issue of fact described above and discussed more particularly in the Memorandum that follows; and

(3) The Motions of the PERA staff, the Represented Petitioners, and Petitioner Bryan F. Brown for Summary Disposition shall remain under advisement pending further orders of the undersigned Administrative Law Judge.

Dated: May 20, 2010

s/Bruce H. Johnson
BRUCE H. JOHNSON
Administrative Law Judge

MEMORANDUM

I. Prior Proceedings

In September 2008, the City of Duluth (City) advised PERA that since 1996, the City had erroneously treated certain amounts paid to, or on behalf of, its employees as "salary" for PERA reporting purposes, and that the City had erroneously made employer/employee contributions to PERA based on those amounts. The City then provided PERA with payroll records. From its review of those records, PERA concluded the City had, in fact, been erroneously reporting certain amounts as "salary." Thereafter, PERA sent letters to active and retired employees of the City, informing them of PERA's determination and advising them how that determination would affect their past, present, and future benefits. Those letters also advised the employees of amounts of any past benefits that had been overpaid and what PERA determined each employee's future benefits to be. Finally, PERA's letters advised the employees of their right to petition for review before the PERA Board of Trustees (PERA Board) pursuant

to Minn. Stat. § 356.96. In response to PERA's letters, 70 active and retired city employees petitioned for review.[2]

On July 10, 2009, PERA issued and served Notices and Orders for Hearing on those 70 current and retired City employees, thereby initiating contested case proceedings to resolve issues relating to their petitions for review.[3] On August 13, 2009, PERA filed a Petition for Consolidation of those 70 contested cases. On August 21, 2009, the ALJ conducted a combined pre-hearing conference in all of the pending proceedings. On August 26, 2009, the ALJ issued a Prehearing Order which, among other things, consolidated all 70 contested cases for the purpose of addressing common questions of law, but not necessarily issues of fact. The ALJ established a schedule for addressing any common questions of law through appropriate motions, including motions for summary disposition pursuant to Minn. R. 1400.550, subp. K. The ALJ also established a discovery schedule.

On November 19, 2009, seven active City firefighters filed a motion for summary disposition asserting that compensation, which those firefighters had been receiving from the City at the end of each year and which represented the value of personal leave they had not taken during the year, did qualify as "salary" for purposes of calculating their PERA benefits. Before the ALJ ruled on that motion, those seven firefighters, PERA, and the Represented Petitioners all entered into a Settlement Agreement on January 5, 2010, under which PERA agreed and stipulated that payments for unused personal leave days, which were made pursuant to applicable collective bargaining agreements, would be considered "salary" under Minn. Stat. § 353.01, subd. 10. PERA further agreed that that determination would be retroactive and would also apply to all City firefighters currently employed or retired, regardless of whether or not they were parties to the Settlement Agreement. At that point, four of the issues identified in the Notice of Hearing remained at issue—namely: (1) whether certain employer paid deferred compensation contributions and insurance supplement payments that the City made to and on behalf of the Petitioners were "salary" within the meaning of Minn. Stat. § 353.01, subd. 10; (2) if not salary, whether a statute of limitations bars PERA from recovering past benefit overpayments or reducing future benefits; (3) if no statute of limitations prevents PERA from adjusting past or future benefits, whether some equitable remedy bars PERA from taking such action; and (4) whether, in making PERA benefit adjustments, it is reasonable for PERA to rely on records submitted by the City.

On December 31, 2009, PERA moved for summary disposition in its favor on all remaining issues, contending that certain employer paid deferred compensation contributions and insurance supplement payments were "salary" within the meaning of Minn. Stat. § 353.01, subd. 10, and that neither a statute of limitations nor any available equitable remedy bars PERA from making commensurate adjustments to the Petitioners' past or future benefits. PERA also filed a memorandum of law[4] and several

[2] Notices of and Orders for Pre-Hearing Conference and Hearing (Notices of Hearing) in OAH Docket Nos. 4-3600-20751-5 through 4-3600-20820-5, inclusive, at p. 2.
[3] OAH Docket Nos. 4-3600-20751-5 through 4-3600-20820-5, inclusive.
[4] PERA's Memorandum in Support of Motion for Summary Disposition (Dec. 31, 2009) (PERA's Supporting Memorandum or PERA Mem.).

affidavits in support of its motion. On February 15, 2010, the Represented Petitioners also moved for a summary disposition in their favor. They, too, filed a memorandum of law[5] and several affidavits in support of their motion and in opposition to PERA's motion for summary disposition. Petitioner Bryan F. Brown, Attorney at Law, appearing *pro se*, also filed a motion for summary disposition. Mr. Brown's motion incorporated the Petitioner's Memorandum by reference. On March 16, 2010, PERA filed a memorandum in opposition to the Represented Petitioners' motion for summary disposition.[6]

On April 13, 2010, the ALJ conducted a hearing on the pending motions for summary disposition at which counsel for the represented parties, as well as some Petitioners appearing *pro se*, presented oral argument. At the close of the hearing, the ALJ allowed the parties to supplement the record with post-hearing submissions relating to certain specific issues addressed during oral argument. On April 20, 2010, both PERA and the Represented Parties filed post-hearing submissions.[7] The issues being thus joined, the pending motions for summary disposition are before the ALJ for disposition.

II. Uncontested Facts

PERA manages and administers pension plans for public employees, including the PERA "general" plan (General Plan) and the PERA Police and Fire Plan (P & F Plan). Minnesota Statutes chapters 353, 356 and 356A govern the administration of those plans, which are "governmental plans" pursuant to federal law. The PERA plans therefore enjoy a tax-deferred or "qualified" status, for both federal and state income tax purposes, meaning that the contributions to these plans and the income generated from those contributions are tax deferred until the benefits are distributed to the employee.[8] It is only then that taxable events occur.

The amount of retirement benefits to which an individual is entitled for PERA purposes is determined by a formula utilizing years of services times a percentage factor for each year of service, times the employee's "high five" salary.[9] Minn. Stat. § 353.01, subd. 10, defines "salary" for purposes of calculating PERA benefits. Governmental subdivisions participating in PERA are responsible for reporting "salary" and the correct employer and employee PERA contributions.[10]

In 1994, during contract negotiations between the City of Duluth and its Supervisors' Association (CDSA), the City offered the CDSA a payment toward deferred compensation in lieu of a salary increase because of the City's reluctance to perpetuate

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[5] Petitioner's Memorandum in Support of Motion for Summary Disposition (Feb. 17, 2010) (Pet. Mem.).
[6] PERA's Response in Opposition to Petitioner's Motion for Summary Judgment (Mar. 16, 2010) (PERA's Response or PERA Resp.).
[7] PERA's letter of April 20, 2010 (PERA Submiss.) and the Represented Petitioners' letter of April 20, 2010 (Pet. Submiss.), respectively.
[8] *AFSCME Council 614, 65 and 96, AFL-CIO c. Sundquist*, 338 N.W.2d 560, 565 (Minn. 1983), *appeal dismissed*, 466 U.S. 9, 22 104 S. Ct. 1902 (1984).
[9] Minn. Stat. § 353.01, subd. 17(a) (2009).
[10] Minn. Stat. § 353.27, SUB. 4 (2008).

a "compounding effect of a percentage increase on subsequent negotiations."[11] The City suggested a "deferred compensation" payment.[12] Article 12 of the 1995–1996 Collective Bargaining Agreement (CBA) between the City and the CDSA stated:

> 12.1 The employer shall allow an employee to participate in any deferred compensation plan of the employee's choice which meets the following criteria:
>
> a. It has been approved by the deferred compensation commission.
>
> b. It qualifies under the laws and regulations of the United States, State of Minnesota, Internal Revenue Service.
>
> c. The employer can accomplish any record keeping, data processing, accounting, or administration of the plan by making a reasonable effort.
>
> The employer shall not do any act to change, alter, amend or terminate any employee's deferred compensation plan without first giving at least sixty (60) days' written notice of its intention, and completing the processing of any grievance brought concerning the proposed action, unless law, ruling or order of the Internal Revenue Service requires it.
>
> Beginning January 1, 1995, the employer shall contribute $25 each month to any employee's deferred compensation plan which exists pursuant to this article. Beginning January 1, 1996, the amount of the employer's contribution shall be increased to a sum of $50 each month.[13]

When the deferred compensation payments by the City first became a part of the City's CBAs, the City Auditor's staff worked directly with PERA staff to determine how to report those payments those payments in the City's payroll system.[14] The deferred compensation payments were included in employees' gross salary as part of total compensation and subject to social security tax. The deferred compensation payments made by the City, together with any employee contributions were both shown on paystubs as deductions. PERA staff advised the City to include its deferred compensation payments "in employees' gross salary as part of total compensation and subject to social security tax."[15]

The deferred compensation plans in which the City employees participated were all 457 plans, meaning that they qualified under section 457 of the Internal Revenue Code.[16] The payments could be withdrawn by employees, subject to a penalty and taxes. The employees could also draw on those amounts as loans. Subsequently, Article 12 of the 1997-1999 CBA between the City and the CDSA contained essentially

[11] Petitioner's Memorandum (Pet. Mem.) in Support of Motion for Summary Disposition, p. 3
[12] Pet. Mem., p. 3, and attached Affidavit of John E. Hall, ¶ 3.
[13] Pet. Mem., p. 4 and attached Affidavit of Elizabeth Storaasli, Ex. A.
[14] Pet. Mem., attached Affidavits of Les Bass, paras. 4 and 5; Jackie Morris, ¶ 2; Genevieve Stark, ¶ 2.
[15] Affidavit of Les Bass, ¶ 4.
[16] Morris Aff., ¶ 9; 26 U.S.C. § 457.

the same language as the 1995–1996 CBA, except that it increased the monthly contribution to $75 per month in 1997, $100 per month in 1998 and $125 per month in 1999; it also provided covered employees with the option to use that sum either as a "contribution to a qualifying and approved deferred compensation plan, or for contribution to family-dependent hospital-medical premium, whichever is designated by the employee during the open window for insurance selection, or at the time of a life event."[17] In the 2000-2002 CBA, the amounts continued to increase until the benefit was $224 per month (plus an additional $5 per month for employees enrolled in "plan 3 hospital-medical insurance") for either deferred compensation or toward family-dependent hospital-medical premiums. These amounts remained the same through 2006 and increased to a flat $229 per month in the 2007-2009 CBA between the City and the CDSA.[18]

The CBA between the City and its Firefighters included the same options in the same amounts, also beginning in 1997. Police officers received similar payments, except that the amounts were slightly less through 2006; and beginning in 2007, dropped to $75 per month. Confidential Unit CBAs during this time period included similar options, but the amounts were different, starting at $75 per month in 1997 and increased ultimately to $245 per month in the 2007-2009 CBA. Beginning with the 1995-1996 CBA, the AFSCME Basic Unit received amounts similar to the CDSA, with the same options.[19] With the exception of the first CBA between the City and the CDSA, all subsequent CBAs permitted employees to choose between the deferred compensation and the insurance payment options. During the years when the City's CBAs provided for those payments, most employees chose to direct the funds into deferred compensation plans.[20]

When the City was negotiating its 1995-1996 CBA with the CDSA, John Hall, the President of the CDSA, asked Karl Nollenberger, who was the City's Chief Administrative Officer and who was negotiating the contract for the City, whether the payments for either deferred compensation or family medical coverage that the City was offering would be considered salary for purposes of PERA. "[O]n more than one occasion," Nollenberger assured Hall that the payments would be considered salary.[21]

The State Auditor performs annual audits of the City's finances, which include specific, separate payroll audits.[22] Because the State Auditor's staff works year-round to complete the audit, they have been given space in Duluth's City Hall. In a follow-up note to the audit for the year ending December 31, 2001, the State Auditor noted that the deferred compensation provisions in the CBAs might violate Minn. Stat. § 356.24, which "restricts the amount an employer can contribute, the plan that can be contributed to and what purposes those contributions are for." The note went on to state that "[i]t appears that the contributions made by the City are not in compliance with this

[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] Pet. Mem., p. 5, and attached Affidavit of Jackie Morris, ¶ 12.
[21] Pet. Mem., p. 3 and attached Affidavit of John E. Hall, paras. 2, 3 and 5.
[22] Hall Aff., ¶ 11; Stark Aff., para 1.

statute."[23] However, that same audit note included the hand-written note, "Resolved."[24] The audit note was "resolved" when Les Bass, who was then City Auditor, and Jackie Morris, who was then Manager of Payroll/Personnel Systems, both discussed the issue with the State Auditor staff in 2001. Both recalled that the State Auditor's office focused on the questions of whether the deferred compensation payments were included as income and whether matching payments were required. When the City informed the State Auditor's staff that the City's payments were included in the employees' gross wages and that no employee match was required, the State Auditor listed the issue as "resolved."[25]

In 2005, the memory capacity of the computer system that stored the City's payroll records was limited. As a result the City made the decision in that year to retain only past total payroll amounts but not payroll detail. When this occurred, the amounts of City contributions to employee deferred compensation plans were aggregated with data on other employee pre-tax and after-tax payroll reductions. The City did not retain paper copies of employee paystubs or paychecks.[26]

It was not until sometime in 2006-2007 that the issue of how to treat the City's deferred compensation and family medical coverage payments resurfaced. At that time the City was facing a severe financial crisis, and then City Administrator John Hall asked City department heads to find ways to reduce spending or increase revenue. At that time, City Auditor Wayne Parson offered his opinion to Mr. Hall that the deferred compensation payments were "not in compliance."[27] Mr. Parson did not indicate what he meant about the payments not being "in compliance."[28] On July 31, 2007, Mr. Parson sent the following e-mail message to Chris Arcand of the PERA staff:

> Please see attachments. My interpretation of the information under 'Salary not Subject to PERA Withholding' in the PERA Employer Manual is that these employer paid benefits are not PERA salary and accordingly employee and employer PERA contributions should not be withheld/paid.[29]

However, the only attachments that Mr. Parsons provided to Mr. Arcand were copies of the provisions in the City's CBAs with its bargaining units that provided for the payments. Mr. Parsons did not indicate to Mr. Arcand that the City was including the amounts of the payments in its employees' gross wages. Mr. Arcand replied that he agreed with Mr. Parsons "that these are employer paid benefits, not employee 'that voluntarily reduces the employee's salary.' Therefore they would not be eligible for PERA contributions."[30] Thereafter, sometime between July and September of 2007, the

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[23] Storaasli Aff., Ex. B.
[24] *Id.*
[25] Bass. Aff., ¶ 6; Morris Aff. ¶ 11. *See* Hall Aff., ¶ 11 and Stark Aff., ¶ 10.
[26] Morris Aff., ¶ 16.
[27] Hall Aff., para 12.
[28] *Id*.
[29] PERA Mem., p. 6, Affidavit of Mary Most Vanek, Ex. 8.
[30] PERA Mem., p. 6, Affidavit of Mary Most Vanek, Ex. 8.

City, on its own initiative, began removing the deferred compensation/family medical coverage payments from salary reported to PERA.[31] Neither the City nor PERA notified the City's employees or retirees that this was being done, why it was being done, or that a reduction in PERA benefits would be a likely result. Moreover, throughout the rest of 2007 and most of 2008, PERA continued to send out retirement annuity estimates that were based on salary estimates that included the City's deferred compensation/family medical insurance payments.[32]

On September 15, 2008, Lisa Potswald, who had recently replaced Mr. Hall as the City's Chief Administrative Officer,[33] wrote to Mary Most Vanek, PERA's Executive Director, informing her "about an error made by the City … in the treatment of certain employer-paid benefits as salary subject to PERA taxes."[34] In her letter, Ms. Potswald referred to the payments only as "insurance supplement payments"; she did not refer to any of the payments as being for deferred compensation. The letter stated "[o]ur annual financial statement audit conducted by the Office of the State Auditor did not detect this error." Ms. Potswald directed Ms. Vanek to Mr. Parson, the City Auditor, for answers to follow-up questions.[35]

On September 18, 2008, PERA asked the City to provide payroll information back to 2005 so that contributions to PERA could be audited and recalculated.[36] None of the information that the City provided to PERA was introduced into the record of this proceeding. It is therefore uncertain whether that payroll information identified that the City had been including the deferred compensation/family medical coverage payments in its employees' gross wages. However, the correspondence between the City and PERA that is in the record indicates that the tax status of the City's payments has not been communicated to PERA since issues regarding those payments re-emerged in 2008.[37]

In mid-March 2009, PERA advised most City retirees that their benefits had been recalculated and that they were liable for repayment of overpayments. The monthly reductions ranged from approximately $50 per month to more than $200 per month.

[31] Morris Aff., ¶ 14.
[32] Pet. Mem., attached Affidavit of Pam Wutz, paras. 3 and 7.
[33] Mr. Hall retired on April 28, 2008. (Hall Aff., para 1.)
[34] Storaasli Aff., Ex. E-19.
[35] *Id.*
[36] Morris Aff., ¶ 15 and attachment, Edward Aff., ¶ 11, Ex. 3.
[37] Affidavit of Mary Most Vanek, Exh. 8; Storaasli Aff., Ex. E-19.

The repayment amounts ranged from a couple of thousand dollars to approximately $20,000.[38]

Over the years, PERA has published numerous documents meant to provide guidance to its constituents regarding what should or should not be included as salary for PERA benefit purposes. These documents have not referred to "deferred compensation," except as Minn. Stat. § 353.01, subd. 10(a) may refer to that term, and they have not identified "deferred compensation" as one of the kinds of compensation not includable in salary for PERA purposes.[39] PERA has never issued guidance or expressed a position that payments made by a public employer to be directed to employee deferred compensation plans or for the purchase of family medical coverage do not constitute salary for purposes of calculating PERA benefits.

Approximately 485 retired City employees have received letters from PERA and the City of Duluth advising the recipients that their PERA benefits have been reduced and informing them of their liability for overpayments. According to PERA, the total of the erroneous withheld employee contributions was $1.137 million; the total of the erroneous employer contributions was $1.414 million, and the net overpayments of excess PERA benefits was $1.268 million.[40]

III. Discussion

A. Whether or not the payments the City made to its employees for deferred compensation or family medical insurance were taxed at the time the payments were made may be material to whether they were "salary" for purposes of calculating PERA benefits.

While it is clear from the record that the payments made by the City for deferred compensation accounts or for family medical insurance were subject to social security taxes, evidence of whether those payments were subject to federal or state income taxes is ambiguous, at best. Various affiants characterized the payments as "included in employees' gross salary as part of total compensation,"[41] "as wages on the employees' paystubs,"[42] "part of employees' gross salary"[43] and "as part of gross compensation subject to social security."[44] Neither these statements nor the various paystubs submitted with affidavits clearly indicate whether federal or state income taxes were deducted from the payments at the time they were initially made.

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[38] Pet. Mem. Attached Affidavits of Jame Charbonneau, ¶ 5; Doug Belanger, ¶ 8, John Edward, ¶ 11; David Salveson, ¶ 5; Michael Schiltz, ¶ 6; Terrance Purcell, ¶ 3; Paul Ostman, ¶ 13. Petitioner Bryan Brown, who was the Duluth City Attorney from 2000-2008, was not part of a collective bargaining unit but was also paid deferred compensation which was included in salary for PERA purposes. His retirement benefit was also reduced, but he was notified of the reduction in 2008, several months earlier than the other retirees. *See* Pet. Mem., attached Affidavit of Bryan Brown, paras. 7-9.
[39] Storassli Aff., Exhs. E-1 through E-7.
[40] Pet. Mem., p. 2.
[41] Bass Aff., ¶ 4.
[42] Stark Aff., ¶ 2.
[43] Morris Aff., ¶ 11.
[44] Hall Aff., ¶ 13.

The tax treatment of the payments at issue is a material fact, even though none of the parties identified that issue as such. If the employees paid income taxes on the amounts of the deferred compensation, they resulted in taxable events when paid, and those payments were therefore not really "deferred" wages in any sense of the word. Such payments could therefore be viewed as just another form of current income, part of salary, and includable in salary for purposes of PERA contributions and calculations. Similarly, if the employees paid income taxes on the amounts of payments made for family medical insurance, those payments could be viewed as being no different than payments for family medical insurance the employees might have made from their net wages and, therefore, not really a "fringe benefit."

B. The Record Will Be Held Open for Further Evidentiary Submissions.

The record is ambiguous about the income tax treatment of the payments at issue. Because the ALJ has a responsibility to the PERA Board to compile a complete and accurate record in these proceedings, it is appropriate to give the parties an opportunity to develop a more accurate and complete evidentiary record on that tax treatment issue. It appears likely that, after some further discovery, that issue can be definitively resolved either by stipulation or by uncontested affidavit evidence. In that event, it will be possible for the ALJ to address the merits of the pending motions for summary disposition. If, on the other hand, there is conflicting evidence concerning the tax treatment of the payments at issue, then a limited evidentiary hearing may be necessary.

The ALJ will therefore keep the parties' motions for summary disposition under advisement pending further limited discovery and evidentiary submissions. The parties will therefore have until June 30, 2010, in which to complete any additional discovery that may be necessary. Thereafter, they will have until July 16, 2010, to submit to the ALJ any additional evidence tending to establish whether or not federal or state income taxes were deducted from the payments to deferred compensation accounts or for family medical insurance at the time those payments were initially made by the City. The record will remain open only for that additional evidence, and no further briefing on this matter is necessary.

B. H. J